

Moscow Financial Weekly

For the period April 1 - May 10, 2002
Treasury Attache's office, US Embassy Moscow

Highlights

- Growth gets political
- Upgrades fuel asset appreciation (maybe a little too much)
- A bank collapse shows the need for stronger regulatory reform

Weekly focus: Starts again next week

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	R31.1192	0.01	3.26
Monetary Base*	R728.0 bln	1.49	2.75***
CPI	NA	NA	6.2
International Reserves*	\$38.4 bln	0.79	5.20
RTS Index (end of week)	386.10	-1.38	48.00
Refinancing rate	25	0	0

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

First quarter 2002 results show a moderating **growth** trend, with signs of a sharper slowdown early in the year proving to have been mostly the result of seasonal factors. GDP growth was 3.3% y-o-y during the first quarter vs. 4.8% in Q1 last year. GOR forecasts for full year 2002 growth anticipate some acceleration with the consensus slightly below 4.0%. Medium-term forecasts for '03-'05 suddenly became a hot topic after President Putin's state of the nation speech complained about slowing growth rates. Soon after, MEDT raised its out-year forecasts to show an accelerating growth trend where none had existed before. The new numbers are 3.4-4.4% in 2003, 4.2-5.1% in 2004, and 4.7-5.6% in 2005. Privately GOR officials facing less direct political pressure to show results see relatively constant medium term growth in the 3.5-4.0% range barring a major acceleration in structural reform. Since by most accounts the window for potentially unpopular reforms is closing as the 2003 and 2004 elections approach, GOR reformers are getting caught between increasing pressure for better results and a worsening environment for taking the steps necessary to achieve them. How they get out of this trap is not yet clear. One possibility is an intensive focus on implementing reforms already passed. Another, possibly more tempting, could eventually be to weaken the ruble. Time will tell how the new team at the CBR reacts if and when it begins to feel pressure from the top to push up growth rates.

A moderating trend also shows up in the **trade balance**. According to CBR data, the external trade surplus decreased to \$10.6B in the first quarter of 2002, vs. \$14.2B in the same period of 2001. These results are due to lower exports (dominated by seasonal factors in the first two months of the quarter) and the continued upward trend in imports, driven by moderate real appreciation of the exchange rate and continued strong consumer demand. Higher exports are likely in Q2, based on higher average oil prices.

The **budget surplus** through April totaled R64.8 billion, or 2.1% of GDP. At the same time, Russia's fiscal reserve fund grew to around R100 billion (\$3.2 million) up from R81 billion at the end of 2001.

And the **rating upgrades** just keep coming. In mid-April, the Fitch raised Russia's foreign currency and ruble bond rating from "B+" to "BB-". Moody's increased its currency outlook from positive to stable, and the OECD announced an upgrade in its export credit guarantees price rating from 6 to 5. Among the reasons for the improved ratings: more budget surpluses, prepayments of external debt due in 2003, increase in the international reserves, improved CBR/government cooperation, continued structural reform, and macro stability. The ratings upgrades have come far enough that Russia is now close to being able to attract new classes of institutional investment that cannot invest in securities below a certain grade. That a major pension fund conference is taking place in Moscow this week, reinforces this notion. Attracting pension fund and other institutional funds is a stamp of approval that could help bring discipline to Russian securities markets. However, with the RTS having just passed its pre-crisis peak on growing foreign portfolio capital inflows, there is a risk of too much too soon. At this stage, a major inflow of FDI, which has barely moved in the last two years, would be more welcome than more money chasing Russia's limited supply of "blue chip" securities.

The Central Bank reduced **deposit rates** prior to the May holiday, including the spot-next rate (5 to 0.8%), overnight rate (4 to 2%), and the one-week rate (11 to 5.5%). There initially was speculation that this signaled more active monetary policy by the new CBR team and possibly a desire to push down the ruble. However, with the holiday over the rates are mostly back up. In fact it looks like this was simply a scheme to save the CBR money on interest costs. It figured banks would park their money in CBR accounts for the holiday in any case, so CBR could lower rates without affecting liquidity. Hopefully in the future, the CBR will spend less time thinking about its own profits, and more about how it can engender them in the economy as a whole.

Banking sector

The Central Bank revoked the operating license for **Investment Banking Corporation** (IBC) on April 30, following up on earlier pledges for improved supervision with concrete actions. A week earlier the CBR imposed external management on the bank after it was found that IBC was essentially bankrupt. IAS compliance, a good S&P corporate governance rating, and Western board members, all of which IBC had, could ultimately compensate for the fact that this was, in fact, a pocket bank for Rosneft, which caused the bank's collapse when it pulled out its business. This incident should give pause on several fronts. First, it shows that IAS accounting is not a panacea for

improving transparency or weeding out bad banks. The GOR and CBR's focus on IAS as the standard for admission to a future deposit insurance system and as the driver for restructuring after 2004 thus may be misplaced. Second this highlights in a more general sense the difference between real corporate governance and the bells and whistles that surround it. Corporate governance ratings, especially the kind like S&P's that is commissioned by the ratee, may have a short life in Russia if it is seen as a surrogate for real governance improvements.

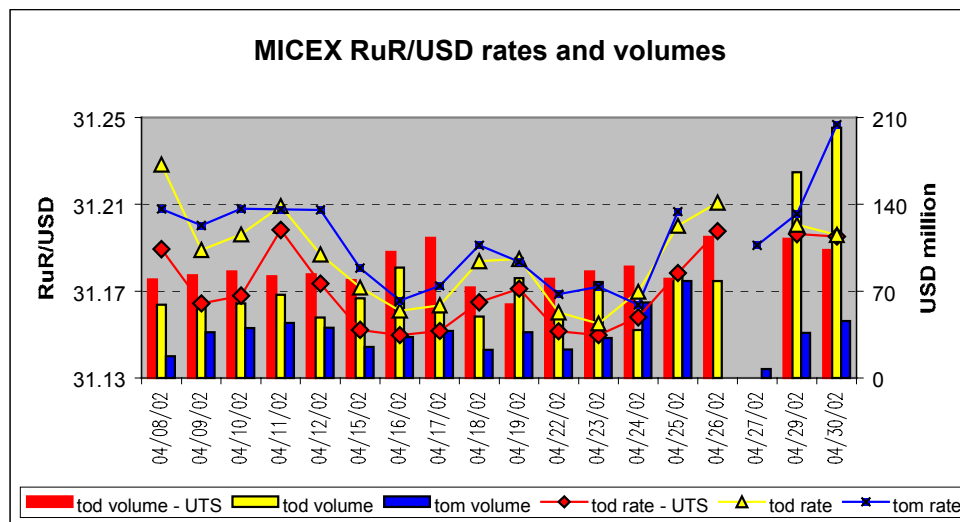
As of May 6, the Central Bank allows non-residents to carry out direct transfers of securities between **S accounts** held by various owners, allowing for sales by non-residents outside the MICEX trading system. On April 29, First Deputy Central Bank Chairman Vyugin announced that some \$3.2 billion trapped in S Accounts would be unfrozen by the end of the year. He noted that for now, periodic auctions would continue, and that liberalization will need to be structured in such a way as to avoid a mass exodus of capital from Russia which could destabilize equity and capital markets.

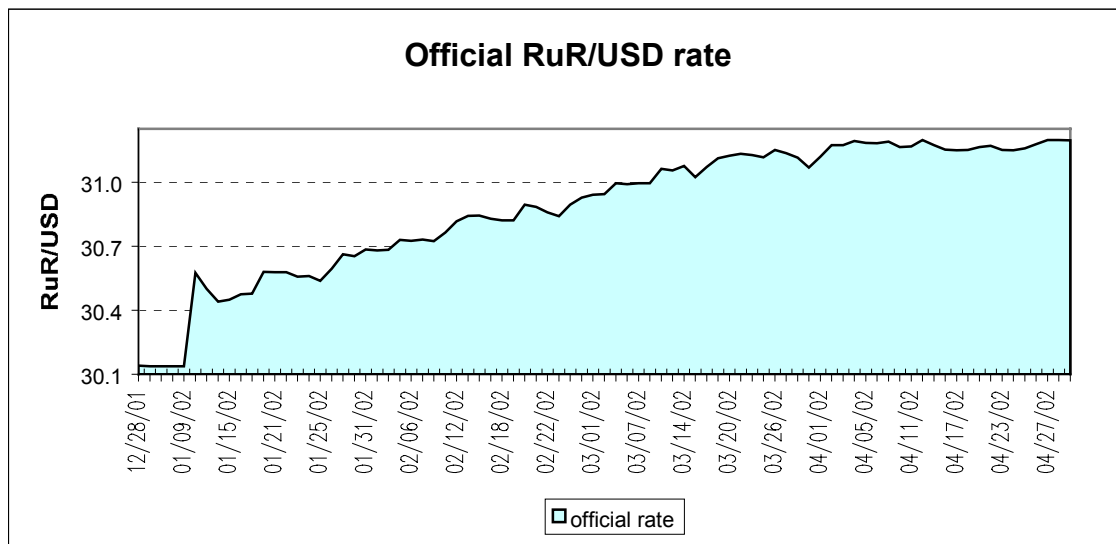
Consideration of the **law on the Central Bank** was temporarily halted, upon written request of Finance Minister Kudrin on April 29, to allow the government time to devise new amendments. Given the change in leadership at the CBR, the driving force to control the bank has been partially mitigated, although the law will need to be amended to allow for transfer of ownership of VTB and Sberbank to the government to begin the privatization process. This would be done by amendment, rather than a separate law, as was envisaged after the second reading on April 5.

In early April, Prime Minister Kasyanov signed a **decree to sell the government's stakes in various banks**, including those with over 25 percent ownership. Combined with the results from the debate on the law of the Central Bank, and other announcements of CBR management, the stage seems to be set for bank privatization beginning this year.

Financial markets

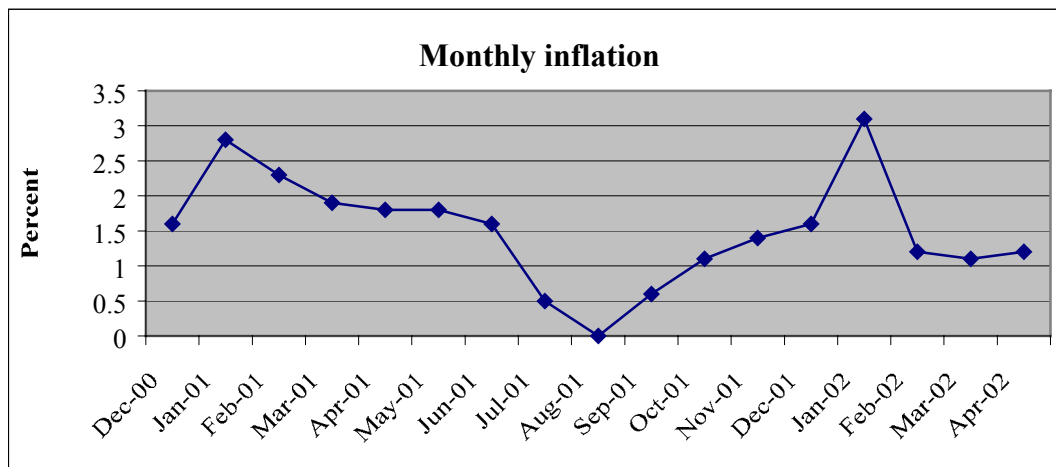
Forex Market





Prices

According to Goskomstat, inflation slowed slightly during March to 1.1% but in April rose back to the level recorded for February (1.2%). Inflation for the first four months of 2002 is 6.6%. Inflation has been held down by delayed hikes in monopoly tariffs earlier in the year. (Inflation was already 7.1% by the end of the first quarter of 2001.)

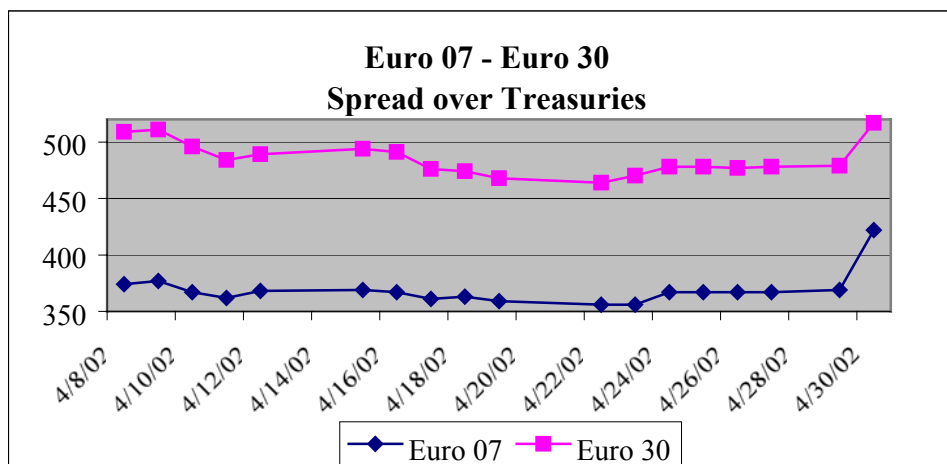
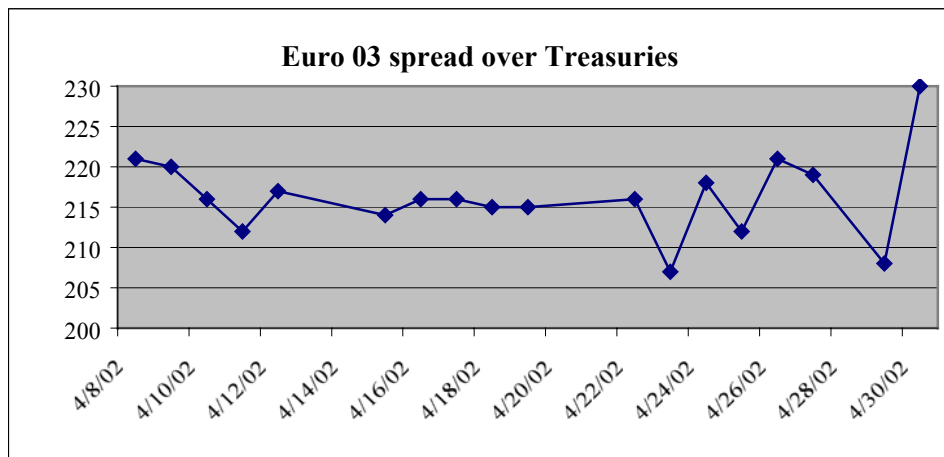


Eurobonds

During the first part of April, prices of Russian Eurobonds were generally rising, supported by the positive dynamics in oil prices and news on the FRG-GOR agreement on transferable ruble debt. Increased trade volumes also supported the upward trend in

prices. In the middle of April, there was a downward price correction. The announcement of the Moody's increase of the Russian rating forecast did not affect prices as this had already been taken into account. Russian bond prices then stabilized and fluctuated in the relatively narrow range through the rest of the month. Overall negative external news (including Argentina) and the previous price increases prevented further market expansion, despite continued high oil prices.

On May 14, Deputy Finance Minister Kolotukhin announced GOR intent to issue new sovereign Eurobonds later this year, noting that a launch would take place only after Russia restructures most of its foreign trade debt. He said terms for the swap would be announced later in May and expects to swap 80% of the FTO debt soon for approximately \$2 billion worth of additional Russia 2030 and 2010 Eurobonds. The remainder, about \$400-450 million, would be swapped in the fall.

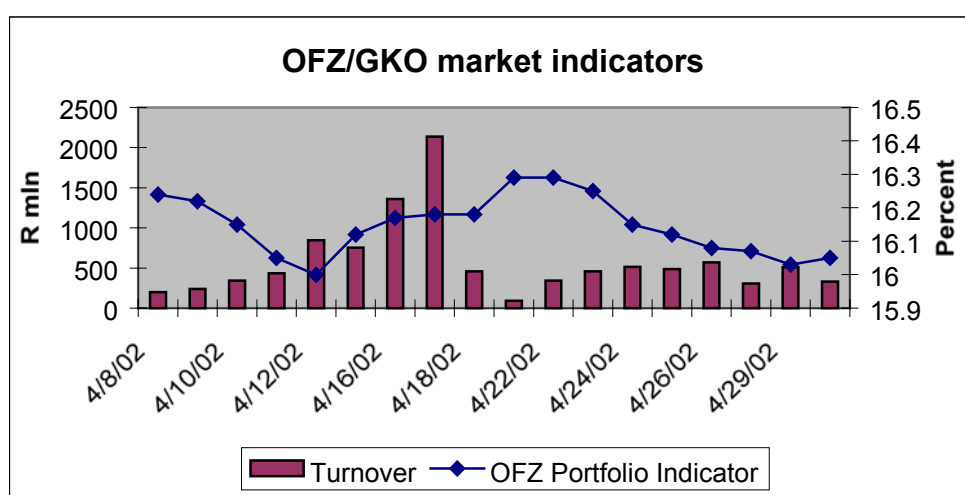


Interest/Bond Market

Bonds/Bills

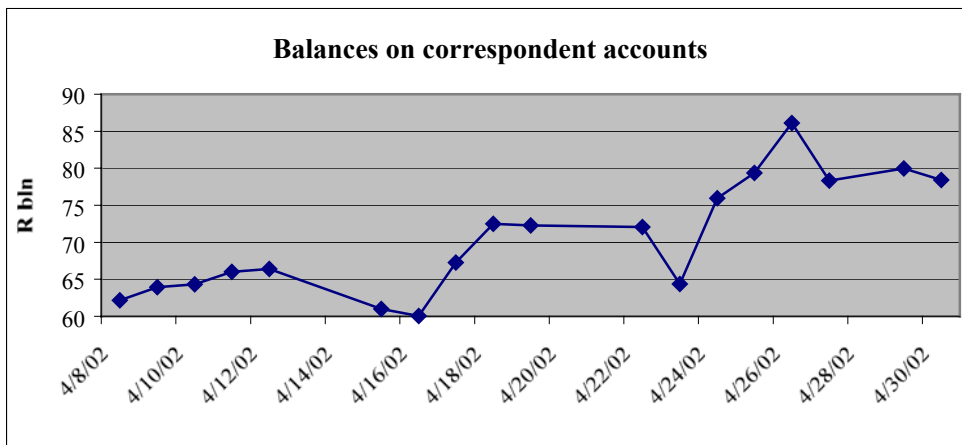
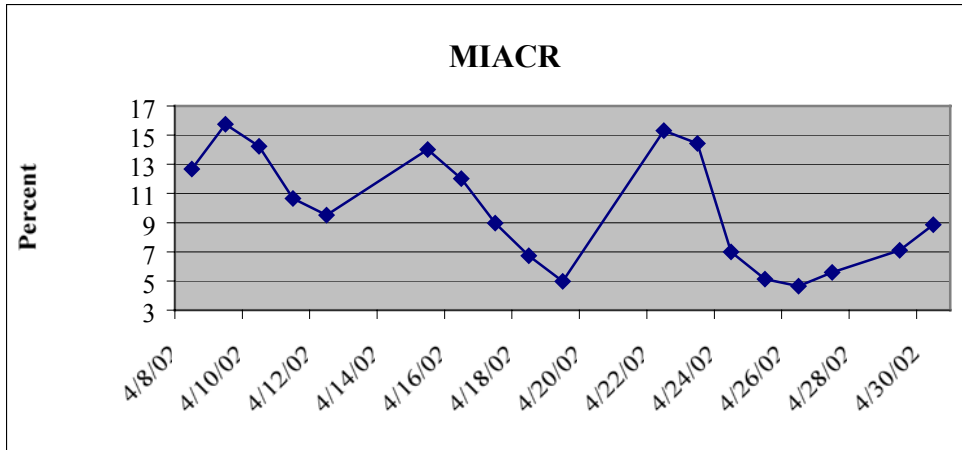
In early April, the market experienced an upward shift initiated by the speculators who were hitting the market before the OFZ auction, and then reinvesting proceeds from the

OFZ coupon payments, which fueled growth further. The Pension Fund debuted as a major player in the first half of April by investing R3.5 billion in OFZ issues held by the Finance Ministry. Later in April, the additional placement of the OFZ issues caused downward pressure on prices as well as increased bank demand for rubles for VAT payments. By the end of the month the situation reversed - the ruble scarcity was eliminated and the coupon payments (approximately R700 million) were almost fully reinvested in the secondary market, causing prices of practically all securities to grow accompanied by slightly lower than average trade volumes. Trading was quiet during the May holidays, but the GKO-OFZ market was higher in advance of May 8 OFZ issues, when MinFin sold R477 million worth of five OFZ issues in the secondary market. It is likely these were purchased by the Pension Fund.



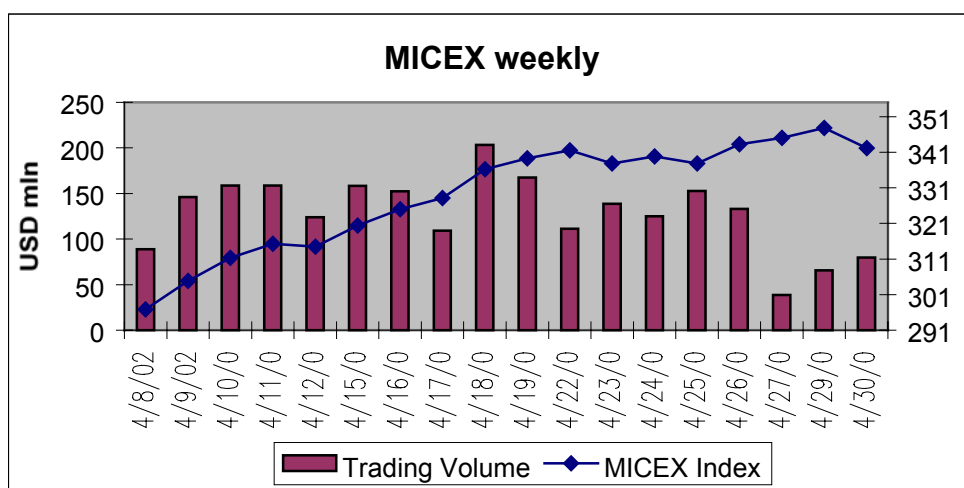
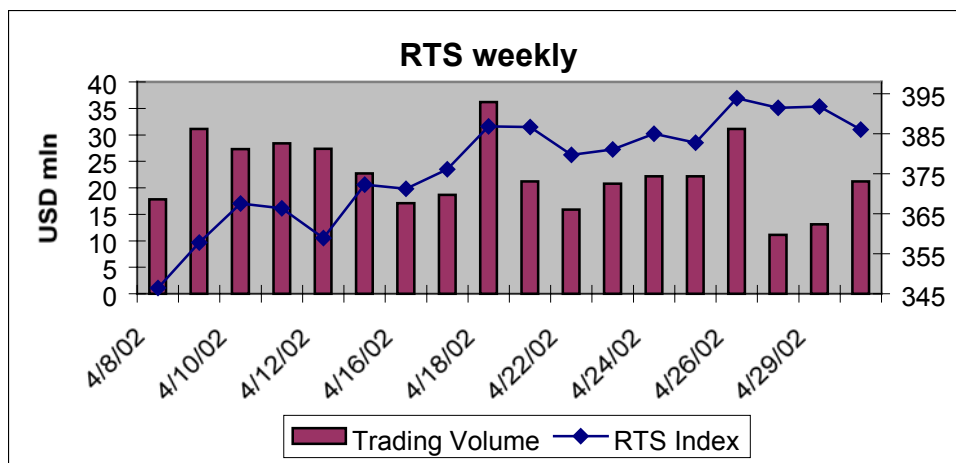
Overnight rates

Ruble liquidity was quite stable in the beginning and in the middle of April. Balances on banks' correspondent accounts fluctuated in the range of R60-70 billion, while the short-term ruble interbank loan rates were slightly above average. The demand for rubles increased sharply when the VAT payments were due at the end of April. After the payments were made banks were left with the excess rubles some of which were reinvested in the secondary OFZ/GKO market. Overnight rates dropped down to quite low levels during the last week of April.



Stock Market

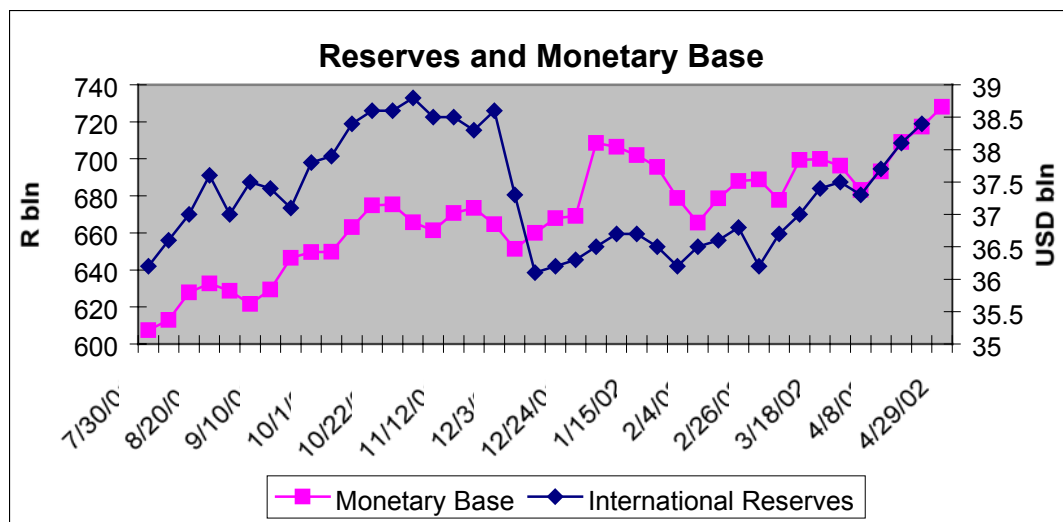
Early in April the market was quiet, as negative dynamics on world markets dominated players' attention. A short downturn based on the negatively perceived announcement of the Deputy Minister of State Property Mr. Braverman about the de-privatization of LUKoil shares sales, was followed by a long-awaited inflow of the fresh money from abroad with the beginning of new quarter (and new financial year for some countries). This resulted in an impressive rally supported by increased trade volumes, continued low interest rates in the US, and political stability. The RTS index reached a new 4-year high of 398 in mid-April. The rally picked up even more steam after the May holidays, with announcements of US-Russia arms reduction agreement and Russia's participation in NATO; the RTS pierced the 400 mark on May 14 reaching levels not seen since early 1998. New money chased a limited number of shares, and as a result the most liquid shares experienced very strong growth. For the month of April, the RTS index was up by 10.1%. Since the beginning of the year the market grew by 48% in dollar terms.



International Reserves and Monetary Base

International reserves gradually grew throughout April. By April 26, they were up to \$38.8 billion, a \$900 million increase since the beginning of the month, and back up to the historical high reached in October 2001. The first week of May they rose to \$39.4 and then on May 10th reached the benchmark level of \$40B.

The monetary base increased continuously during April. During the second week of April it returned to the abnormally high levels seen at the beginning of the year, with unsterilized repatriation of higher oil proceeds primarily responsible. On April 29, it had increased sharply again by R10.7 billion to R728. At the end of April, the money supply was 2.75% higher than in January; for the month base money grew by R44.9 billion or 6.57%.



EXPLANATORY NOTES

1. EXCHANGE RATES: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities,

repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. LOMBARD CREDITS, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.